

D.T.E. 03-75

Petition of Southern Union Company for authorization and approval to issue and distribute up to 7.0 million shares of common stock in order to administer its 2003 Stock and Incentive Plan pursuant to the provisions of G.L. c. 164, §§ 14, 16.

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FOR: SOUTHERN UNION COMPANY  
Petitioner

## I. INTRODUCTION

On August 5, 2003, Southern Union Company (“Southern Union” or “Company”) filed a petition with the Department of Telecommunications and Energy (“Department”) pursuant to G.L. c. 164, § 14, for authorization and approval to issue and distribute up to 7,000,000 shares of common stock in order to administer its 2003 Stock and Incentive Plan (“the Plan”). There were no intervening parties. The Department docketed the filing as D.T.E. 03-75.

Pursuant to notice duly issued, the Department conducted public and evidentiary hearings at the Department’s offices on September 15, 2003. In support of its petition, the Company offered the testimony of Richard N. Marshall, Vice-President and Treasurer for Southern Union. The evidentiary record consists of eight exhibits and three responses to record requests. On October 15, 2003, the Company submitted Post-Hearing Comments in support of its petition.

## II. DESCRIPTION OF THE COMPANY’S PROPOSAL

Southern Union proposes to issue up to 7,000,000 shares of common stock for the purpose of offering employees performance incentives in the form of stock options (Exh. SU-1, at 3; Brief at 2). Salaried employees and officers of the Company are eligible for the Plan, however directors are ineligible (Tr. at 7). According to the Company, a committee, with detailed information from senior management, determines which employees have the most direct effect and make the greatest contribution to the Company’s operations regarding profitability, safety and reliability (*id.* at 7-8). The committee is composed of outside directors, who do not receive compensation from the Company and who are not past officers of the Company (Exh. RR-DTE 1-2; Tr. at 18). Once the Company determines that it will

grant incentive options, it sets a date to grant the options (Tr. at 8-9). The maximum award to each employee is 200,000 shares (id. at 12). An option must vest before the employee may exercise that option (id. at 9-10). Typically, the options vest over time, so that employees may exercise a portion of the options each year until all are vested (RR-DTE-1-3; Tr. at 9-10). Employees may exercise an option as soon as it vests for the “exercise price” (Tr. at 9-10). The exercise price is the closing market price of the stock on the day the option is granted (id. at 8-9). The Company makes seven different types of awards: incentive options, non-statutory options, stock appreciation rights, stock awards, performance units and dividend equivalents (Exh. RR-DTE-1; Tr. at 14-15).

Accordingly, the Company is requesting authorization for a total of 7,000,000 shares for the purpose of offering employees performance incentives in the form of stock options (Exh. SU-1, at 3, Brief at 2). In compliance with G.L. c. 164, § 14, the Company certified to the Department that the Board of Directors authorized the issuance prior to the issuance of dividend shares by a vote of the Board on July 22, 2003.<sup>1</sup> First, Southern Union contends that the Plan has a positive, albeit, indirect effect on customers (Tr. at 16). According to the Company, the purpose of the Plan is attracting and retaining experienced employees who will effectively operate the Company, and providing an incentive to those employees to provide

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<sup>1</sup> In all future § 14 filings, the Department will require that, at the time of the initial filing, the petitioner or applicant shall file an original document bearing the certification of the corporate officer (customarily the corporate secretary ) duly appointed and authorized to attest to the state of the petitioner’s corporate records. Such certification shall establish that the corporate directors have voted duly to authorize the issuance of the stock subject to the petition “not more than four months prior to such application” in accordance with § 14. Failure to include such certification on the date of the filing may risk rendering the application deficient on its face.

customer service, safety and reliability (Tr. at 16-17) . Furthermore, the Company maintains that the Plan has no negative effect on customers (id. at 17).

Second, the Company asserts that issuance of additional shares of common stock will assist the Company in maintaining adequate equity ratios and ensuring that the Company's cost of debt is consistent with its investment grade (Exh. SU-1, at 7). The Company states that issuing shares to employees is a cost-effective way of maintaining adequate equity ratios because it defrays the need for, and the size of, common stock issuances in the public markets (Exh. SU-1, at 7; Brief at 5). The Company contends that common stock issuances in the public market involve transaction expenses such as underwriter fees, brokerage commissions, fees to the Securities and Exchange Commission, legal expenses and documentation expenses, all of which are avoided by issuing stock for the Plan (Exh. SU-1, at 7).

### III. CAPITAL STRUCTURE OF THE COMPANY

As of June 30, 2003, Southern Union's utility plant (including \$75,484,000 in construction work in progress ("CWIP")) was \$3,747,858,000 (Exh. SU-2 (Rev.)). After removing \$641,225,000 in accumulated depreciation and amortization, the Company reported a net utility plant of \$3,106,633,000 (id.). In addition, Southern Union had \$160,680,000 in gas inventories (id.). Thus, as of June 30, 2003, the Company had a net utility plant and gas inventory balance of \$3,267,313,000 (id.).

As of June 30, 2003, the Company reported a total capitalization of \$3,366,842,000, consisting of (1) \$2,221,405,000 in long-term debt, (2) \$100,000,000 in preferred securities of a subsidiary trust, (3) \$125,000,000 in mandatory convertible securities, and (4) \$920,437,000 in common equity (id.). The Company's common equity balance included retained earnings of

\$24,347,000 (id.).

Southern Union proposed a number of adjustments to these capitalization and net utility plant balances (Exhs. SU-1, at 9-10; SU-2 (Rev.)). First, the Company excluded \$5,865,000 (\$16,861,000 in plant, less accumulated depreciation of \$12,584,000, as well as gas inventories of \$1,588,000) from net plant in service to remove plant associated with unregulated operations (Exh. SU-2 (Rev.)). The Company then eliminated an additional \$75,484,000 in CWIP from its property, plant and equipment accounts (id.). Finally, the Company removed \$12,069,000 from plant in service and \$3,276,000 in accumulated depreciation associated with a leased automated meter reading (“AMR”) system used at its Missouri Gas Energy division (id.). As a result of these adjustments, the Company’s net utility property, plant and equipment in service amounted to \$3,177,171,000 (id.).

In recognition of the above plant adjustments, the Company made corresponding adjustments to its capitalization. First, the Company reduced its total capitalization by \$4,558,000, based on a pro rata reduction to long-term debt, preferred securities, and premiums on common stock (id.).<sup>2</sup> Second, the Company excluded \$619,052,000 associated with acquisition premiums, representing the excess of the purchase price over book value of several natural gas utilities acquired in recent years (id.).<sup>3</sup> Third, the Company excluded from capitalization retained earnings of \$24,347,000 (id.). Finally, the Company excluded from

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<sup>2</sup> The Company’s unregulated operations have been supported over the years through a combination of debt and equity (Exh. SU-1, at 12).

<sup>3</sup> The Company stated that it has financed its acquisitions over the years through a combination of debt and equity and cannot directly attribute the acquired facilities to specific capital sources (Exh. SU-1, at 13).

long-term debt \$8,793,000 in capitalized leases associated with its AMR system (id.). As a result of these adjustments, the Company's total capitalization amounted to \$2,710,092,000 (id.).

#### IV. STANDARD OF REVIEW

In order for the Department to approve the issuance of stocks, bonds, coupon notes, or other types of long-term indebtedness<sup>4</sup> by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985) ("Fitchburg II"), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) ("Fitchburg I"). Second, the Department must determine whether the Company has met the net plant test.<sup>5</sup> Colonial Gas Company, D.P.U. 84-96 (1984).

The Supreme Judicial Court has found that, for the purposes of G.L. c. 164, § 14, "reasonably necessary" means "reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency." Fitchburg II, 395 Mass. at 836, citing Lowell Gas Light Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946). In

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<sup>4</sup> Long-term refers to periods of more than one year after the date of issuance. G.L. c. 164, § 14.

<sup>5</sup> The net plant test is derived from G.L. c. 164, § 16.

cases where no issue has been raised about the reasonableness of management decisions regarding the requested financing, the Department limits its Section 14 review to a determination of reasonableness of the Company's proposed use of the proceeds of a stock issuance. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); *see, e.g., Colonial Gas Company*, D.P.U. 90-50, at 6 (1990). The Fitchburg I and II and Lowell Gas cases also established that the burden of proving that an issuance is reasonably necessary rests with the company proposing the issuance, and that the Department's authority to review a proposed issuance "is not limited to a 'perfunctory review.'" Fitchburg I, 394 Mass. at 678; Fitchburg II, 395 Mass. at 841, *citing Lowell Gas*, 319 Mass. at 52. Regarding the net plant test, a company is required to present evidence that its net utility plant (original cost of capitalizable plant, less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding) and will continue to do so following the proposed issuance. Colonial Gas Company, D.P.U. 84-96, at 5 (1984).

Where issues concerning the prudence of the company's capital financing have not been raised or adjudicated in a proceeding, the Department's decision in such a case does not represent a determination that any specific project is economically beneficial to a company or to its customers. In such circumstances, the Department's determination in its Order may not in any way be construed as ruling on the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. *See, e.g., Boston Gas Company*, D.P.U. 95-66, at 7 (1995).

V. ANALYSIS AND FINDINGSA. Issuance of Stock Dividends1. "Reasonably Necessary" Standard

First, Southern Union contends that its proposal to issue up to 7,000,000 shares for administering an employee stock option plan is for the purpose of attracting and maintaining skilled employees (Exh. SU-1, at 4; Tr. at 16; Brief at 7). In addition, the Company states that the employee stock option plan provides an additional incentive for employees to effectively operate the Company (Tr. at 16). The Department has found previously that the issuance and sale of stock is reasonably necessary to provide long-term financial incentives to attract and maintain employees. Essex Gas County Company, D.P.U. 97-71, at 6-7 (1997).

Second, the Company contends that the issuance of 7,000,000 shares of stock would improve the Company's debt-to-equity ratio because the proceeds from the sale of stock to employees exercising their options would be used to repay long-term debt and capital lease obligations (Exh. SU-1, at 9-10; Tr. at 20; Brief at 7). The Company states that improvement of the debt-to-equity ratio enables the Company to maintain access to cost-effective capital (Exh. SU-1, at 9; Tr. at 20; Brief at 7). The record demonstrates that the issuance of common stock would improve the Company's debt-to-equity ratio (Exh. SU-1, at 7). The Department has found previously that the issuance of stock for the purposes of acquiring and maintaining equity is a "legitimate utility purpose" as contemplated by G.L. c. 164, § 14. Southern Union Company, D.T.E. 03-3, at 18 (2003); Bay State Gas Company, D.P.U. 93-14, at 14 (1993); Colonial Gas Company, D.P.U. 90-50, at 6. Therefore, the Department is persuaded that issuance of stock would improve the Company's debt-to-equity ratio, thereby maintaining the



Company's access to cost-effective capital. Accordingly, the Department finds that the proposed issuance of not more than 7,000,000 shares of common stock for the purpose of administering its 2003 Stock Option and Incentive Plan is reasonably necessary to accomplish a legitimate purpose in meeting the Company's service obligations in accordance with G.L.c. 164, § 14, and therefore meets the first prong of the Department's two-prong standard.

## 2. Net Plant Test

In regard to the net plant test, the Department requires companies to demonstrate that their net utility plant equals or exceeds their total capitalization pursuant to G. L. c. 164, § 16. Colonial Gas Company, D.P.U. 84-96, at 5. Southern Union has proposed a number of adjustments to its actual capital structure to demonstrate that the proposed stock issuance meets the Department's net plant test.

First, the Company has proposed to exclude CWIP from its plant investment balance and to exclude retained earnings from its capitalization (Exh. SU-2 (Rev.)). The Department has found previously that CWIP and retained earnings should be excluded from a company's plant and capitalization accounts for purposes of the net plant test calculation. Southern Union Company, D.T.E. 01-52, at 9; New England Power Company, D.P.U. 92-189, at 7 (1992); Colonial Gas Company, D.P.U. 84-96, at 8. Accordingly, the Department finds that Southern Union's adjustments to exclude CWIP and retained earnings are appropriate.

Southern Union has also proposed to exclude unregulated property, plant and equipment in service and the capital used to finance those assets from the net plant calculation (Exh. SU-2 (Rev.)). The Department construes the term "fair structural value of the plant", as used in G.L. c. 164, § 16, to include only plant that is actually used and useful in providing

utility service to ratepayers. The costs associated with unregulated operations, including those associated with capital costs, should not be borne by ratepayers. NYNEX Price Cap,

D.P.U. 94-50, at 440 (1995); Colonial Gas Company, D. P. U. 84-94, at 51 (1984).

Therefore, the Department finds that the Company has appropriately excluded its investments and capital associated with unregulated operations. Southern Union Company, D.T.E. 01-52, at 9-10 (2001); Southern Union Company, D.T.E. 01-32, at 10-11 (2001). See also NYNEX Price Cap, D.P.U. 94-50, at 440; Colonial Gas Company, D.P.U. 84-94, at 51 (1984).

Similarly, the Company's proposed adjustment for acquisition premiums is appropriate, given that an acquisition premium, or goodwill, is intangible and, as such, should be excluded as a component in a utility's plant for purposes of G.L. c. 164, § 16. Southern Union Company, D.T.E. 02-27, at 12; Southern Union Company, D.T.E. 01-32, at 11 (2001). Accordingly, the Department finds that the Company appropriately excluded acquisition premiums from its capital structure.

Southern Union initially included \$12,069,000 in its plant accounts and \$3,276,000 in accumulated depreciation, along with \$8,793,000 in capital lease obligations attributable to its AMR system (Exh. SU-2 (Rev.)). Regardless whether the AMR lease is considered to be capitalizable under generally accepted accounting principles, the Department has determined that capitalized leases do not constitute long-term debt issues under the definition set forth in G.L. c. 164, § 14. Southern Union Company, D.T.E. 03-46, at 14 (2003); NYNEX Price Cap, D.P.U. 94-50, at 436-437. Additionally, because a utility does not hold leased plant in fee, utility plant associated with capitalized leases would not be included in plant. Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 71 (2002). Therefore, the Department

will exclude the net \$8,793,000 in AMR equipment and associated capitalized leases from the Company's net plant and capitalization.

The record demonstrates that, with the issuance of up to 7,000,000 shares of common stock for the purpose of administering the Plan, Southern Union's total capital stock and long-term debt will not exceed the Company's net utility plant following the stock issuance (Exh. SU-3 (Rev.)). After these adjustments, the Company's adjusted utility plant amounted to \$3,177,171,000 which is \$467,079,000 more than its adjusted capitalization of \$2,710,092,000 (id.). Accordingly, the Department finds Southern Union's stock issuance for the purpose of implementing a stock option plan for employees meets the net plant test as provided in G.L. c. 164, § 16.

As noted above, the actual amount and composition of the Company's stock issuance will not be final until a later date. The Department directs the Company to provide the Department with the following information within 30 days of the issuance: (1) the type of stock issued; (2) the number of preferred shares issued; and (3) the face value of the stock issued.

## VI. ORDER

Accordingly, after due notice, hearing, and consideration, the Department:

VOTES: That the issuance and distribution by Southern Union Company of no more than 7,000,000 shares of common stock for the purpose of administering the Company's 2003 Stock and Incentive Plan is reasonably necessary for the purposes for which such issuance and sale has been authorized, pursuant to G.L. c. 164, § 14.

VOTES: That the issuance and distribution by Southern Union Company of no more than 7,000,000 shares of common stock for the purpose of administering the Company's 2003 Stock and Incentive Plan is in accordance with G.L. c. 164, § 16, in that the fair structural value of the Company's property, plant and equipment and the fair value of the gas inventories held by the Company will exceed its outstanding stock and long-term debt; and

VOTES: That the issuance and distribution by Southern Union Company of no more than 7,000,000 shares of common stock for the purpose of administering the Company's 2003 Stock and Incentive Plan is approved and authorized; and it is

ORDERED: That the issuance and distribution by Southern Union Company, in conformity with all the provisions of law relating thereto, of up to 7,000,000 shares of common stock for the purpose of administering the Company's 2003 Stock and Incentive Plan is authorized and approved; and it is

FURTHER ORDERED: That Southern Union Company comply with all the directives in this Order; and it is

FURTHER ORDERED: That the Secretary of the Department shall within three days of the issuance of this Order cause a certified copy of it to be filed with the Secretary of State of the Commonwealth.

By Order of the Department

/s/

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Paul G. Afonso, Chairman

/s/

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James Connelly, Commissioner

/s/

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W. Robert Keating, Commissioner

/s/

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Eugene J. Sullivan, Commissioner

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Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).